

**CAPITAL RULES UNDER
THE COMPANIES ACT 71 OF 2008, WITH EMPHASIS ON
FINANCIAL ASSISTANCE**

by

NERINA ERASMUS

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Summary

Company law traditionally regulated capital by use of the capital maintenance principle. The Companies Act 71 of 2008 replaces the capital maintenance regime with one based on solvency and liquidity.

This dissertation aims at analysing the capital rules relating to financial assistance as they are contained in the Companies Act 71 of 2008. This includes the provision of financial assistance for the purpose of or in connection with the purchase or subscription of securities in the company (section 44) and the provision of financial assistance to directors and prescribed officers of the lending company or of a related or inter-related company, or to a related or inter-related company (sections 45). The solvency and liquidity test, which is required to be applied when a company intends to provide financial assistance is analysed at the outset of the study. The work of renown authors are used for purposes of the study.

The solvency and liquidity test comprises of two elements, namely solvency and liquidity. Each element of the test as well as the assets to be considered and valuation thereof is analysed. The greatest problem with regard to the test is which assets to include when the company is part of a group of companies and the lack of provision for the protection of preferential liquidation rights in all instances. Clarity is called for in these regards. Where there is a question as to valuation method of the assets, it is submitted that it is best left to be determined by the directors.

The provision of financial assistance in terms of section 44 is analysed in detail. The provision of financial assistance to a person for the purpose of or in connection with the purchase of securities in a company is allowed, subject to certain conditions and requirements. Companies are also allowed to impose further conditions or requirements in the Memorandum of Incorporation. The key terms are defined and analysed, as well as the conditions or requirements for the provision of financial assistance. The scope of application of the section is cast incredibly wide due to the wide definition of “*securities*” and the extension of the application to financial assistance for securities in a “*related or inter-related*” company.

The provision of financial assistance in terms of section 45 is analysed in the same manner (albeit in less detail) as section 44. The biggest problem here again is its wide scope of application due to the extension of application to provision of financial assistance to a “*related or inter-related*” company or director or a prescribed officer thereof.

Key words: solvency and liquidity test; financial assistance; for purpose of or in connection with subscription or purchase of securities; financial assistance to directors; financial assistance to company in same group; related or inter-related.

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1. INTRODUCTION

1.1 Background

In 1998 the Department of Trade and Industry announced its long-awaited intention to review South African company law¹. The reform process was to be done in two phases – the first was the interim review, which brought about amendments to the Companies Act 61 of 1973 that were deemed to be of a more urgent nature², and the second was a more comprehensive reform of the Companies Act as a whole, by the drafting of a New Companies Bill³. The objectives for reform of the Act (as a whole) were set out in a policy document, *South African Company Law for the 21st Century - Guidelines for Corporate Reform*, published in the Government Gazette in 2004⁴. The Companies Bill was published for comment in February 2007 and the final D-version of the Bill (albeit very different to the initial draft in both form and substance) was passed by Parliament on 19 November 2008⁵ and signed by the President on 8 April 2009. The Companies Act 71 of 2008 is expected to come into force during 2010⁶.

One of the most important and significant changes documented in the policy document and brought about by the New Companies Act⁷ is that relating to the regulation of the capital of a company. The development of the regulation is discussed hereafter.

The capital maintenance rule, as developed or entrenched in the English case *Trevor v Whitworth (1887) 12 App Cas 409, LH* has applied in South African company law since its commencement⁸, and has traditionally been maintained as the ultimate way to protect creditors⁹ and prevent shareholders from being favoured above creditors through a partial liquidation of the company. The rule

¹ General Notice 724 of 1998, Government Gazette 18868 of 8 May 1998

² This was done by way of The Companies Amendment Act 37 of 1999

³ JL Yeats *The Drafter's Dilemma: Some comments on the Corporate Laws Amendment Bill, 2006* 2006 SALJ Volume 123 page 600 (this article is based on the Corporate Laws Amendment Bill as published in April 2006)

⁴ General Notice 1183 of 2004, Government Gazette 26493 of 23 June 2004

⁵ K van der Linde *The Regulation of Share Capital and Shareholder Contributions in the Companies Bill 2008* 2009 TSAR Volume 1 at page 39

⁶ The Act may come into force on date not earlier than a year after signature and proclamation by the President, i.e. not earlier than 8 April 2010.

⁷ 71 of 2008

⁸ Pretorius, Delport, Havenga & Vermaas *Hahlo's South African Company Law through the cases, 6th Edition* 1999 Juta&Co Ltd

⁹ D Bhana *The Company Law Implications of Conferring a Power on a Subsidiary to Acquire the Shares of Its Holding Company* 2006 Stell LR Volume 17

developed as an extension of the *ultra vires* rule¹⁰ and entails that “*the contributed (paid-up) capital of a limited company constitutes the fund to which the creditors of the company must look for satisfaction of their claims, and that [therefore] the fund must be maintained*”¹¹.

The Companies Law Amendment Act 37 of 1999 replaced certain of the provisions of the Companies Act 61 of 1973 based on the capital maintenance principle with provisions based on solvency and liquidity. The Amendment Act¹² was therefore a great turning point for share capital, as the Act¹³ finally recognised that there are other sufficient ways to not only provide creditors with sufficient (if not better) protection, but to also provide companies with more flexibility. These amendments were also a step in the right direction in bringing South African company law in line with modern trends in other jurisdictions and thereby making South African Companies more internationally competitive¹⁴.

However, although welcomed, the Amendment Act¹⁵ did not succeed in fully completing the transformation to a solvency and liquidity regime¹⁶ and also contained a number of anomalies and ambiguities¹⁷. Further reform in the field was therefore not only desirable, but also necessary.

The Companies Act 71 of 2008 has finally taken the leap and discarded any remnants of the capital maintenance principle¹⁸. This change is long overdue. The regulation of capital is now fully based on a solvency and liquidity regime. Included in this regulation are the rules relating to financial assistance for the subscription or purchase of securities in a company¹⁹ and the provision of financial assistance to directors or related or inter-related companies²⁰.

¹⁰ Cilliers, Benade, Henning, Du Plessis, Delpport, De Koker, Pretorius *Cilliers & Benade Corporate Law, 3rd Edition* 2000 LexisNexis Butterworths at page 322

¹¹ Cilliers, Benade, Henning, Du Plessis, Delpport, De Koker, Pretorius *Cilliers & Benade Corporate Law, 3rd Edition* 2000 LexisNexis Butterworths at page 322

¹² 37 of 1999

¹³ 37 of 1999

¹⁴ F H I Cassim *The New Statutory Provisions on a Company Share Repurchases : A critical Analysis* 1999 SALJ Volume 116

¹⁵ 37 of 1999

¹⁶ Cilliers, Benade, Henning, Du Plessis, Delpport, De Koker, Pretorius *Cilliers & Benade Corporate Law, 3rd Edition* 2000 LexisNexis Butterworths

¹⁷ Yeats *The Drafter's Dilemma: Some comments on the Corporate Laws Amendment Bill, 2006* 2006 SALJ Volume 123

¹⁸ P Delpport *The New Companies Act Manual* 2009 LexisNexis

¹⁹ Section 44

²⁰ Section 45

1.2 Purpose and Problem Statement

As the 2008 Act has not yet come into operation and the courts and practice have not had an opportunity to interpret or clarify any matters in need thereof, there remains a lot of uncertainty surrounding many provisions in the New Companies Act and their application. As the principles relating to capital are now fully based on a regime of solvency and liquidity, a completely alternative system, the statutory provisions relating to such capital contain new concepts, not yet familiar to the South African law community. Although the Companies Amendment Act incorporated the solvency and liquidity approach in certain instances, the provisions in the Companies Act 71 of 2008 follow a completely different approach to the Amendment Act.

It is unfortunate that the policy document and the explanatory memorandum do not outline the considerations that informed the proposals regarding capital rules in any detail²¹.

The purpose of this dissertation is to analyse the provisions containing the Capital Rules relating to financial assistance in the Companies Act 71 of 2008 (and other provisions related thereto), and as far as possible to clarify uncertainties surrounding such provisions and their application. I will also look at some of the major potential problem areas and pose suitable solutions where possible.

As stated above the focus of this dissertation is on the rules relating to financial assistance, namely the provision of financial assistance for the purpose of or in connection with the purchase of securities in a company, and the provision of financial assistance to directors or prescribed officers or related or inter-related companies. The main focus will be on the aforementioned financial assistance.

The provision of financial assistance for the purchase of shares is a very relevant topic, as the new rule contained in section 44 of the Act will provide impetus for black economic empowerment transactions, which were previously largely hampered by the prohibition against such assistance. This rule is also one which was not fully transformed by the Companies Amendment Act²², and the principles of solvency and liquidity are therefore completely new to this capital rule.

The provision of financial assistance to directors or prescribed officers of the company itself or of a related or inter-related company or to a related or inter-

²¹ Van der Linde *The Regulation of Share Capital and Shareholder Contributions in the Companies Bill 2008* 2009
TSAR Volume 1

²² 37 of 1999

related company is now dealt with in one section, namely section 45. The provision is not dealt with in great detail in this study, as the main focus rests on section 44, but I deemed it important to allude to such section, due its close connection with section 44.

1.3 Delineation

This dissertation is limited to the Capital Rules relating to financial assistance as mentioned above. All other capital rules fall outside the scope of this study.

In the analysis of the capital rules contained in Chapters 3 and 4, reference is made to director's liability. I will allude to such liability and the extent of such liability, but an in depth discussion of director's liability and its interaction with the common law (if any) falls outside the scope of this study.

The definition of "related parties" contained in 3.2.5 below only covers the definition as far as it is most relevant for purposes of Chapters 3 and 4 and its application in practice, and does not seek to be a comprehensive definition for all scenarios.

1.4 Research Methodology

The Companies Act 71 of 2008 provides the foundation and starting point for the study undertaken. The policy document²³ and where possible case law are used as further primary sources.

As secondary sources, the writings, articles and commentaries of prominent South African authors are used in the evaluation of the provisions in the Act, relevant principles underlying such provisions, and application thereof. Journal articles from recognised academic law journals proved to be useful in this area.

Where comparison is drawn to the Companies Act 61 of 1973 (as amended) the Act itself²⁴ (as amended) and case law was used as primary sources. Textbooks and journal articles of renowned authors were used as secondary sources.

Very little literature is available on section 45. However, as the wording and underlying principles of section 45 appear to be largely based on that of section 44, a comparative approach is taken in the analysis of such section.

The principal research methodology embarked on was a literature study, except for the analysis of section 45, where a comparative study was undertaken.

²³ *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* Notice 1183 of 2004
Government Gazette 26493 of 23 June 2004

²⁴ Reference to the Act here is to the Companies Act 61 of 1973

1.5 Chapter Overviews

Chapter 1, The Introduction, will hereafter be concluded with the definitions of terms and concepts regularly used in this dissertation.

Chapter 2 contains a detailed analysis of the Solvency and Liquidity test as contained in section 4 of the Act. The solvency and liquidity elements are each dealt with separately, where after the assets and the valuations of such assets that are to be considered in the test will be analysed. The problem surrounding preferential liquidation rights is also considered, as well as timing issued of the test and further general comments.

Chapter 3 covers Section 44 of the Act, namely the provision of financial assistance for the purpose of or in connection with the purchase or subscription of shares in the company. The key terms are defined and the conditions or requirements for the provision of assistance are analysed. Consequences of non-compliance with the Act or the Memorandum of Incorporation are also dealt with.

Chapter 4 briefly looks at Section 45 of the Act, which section regulates the provision of financial assistance to directors, prescribed officers, members and companies within the same group. The definitions of terms and concepts, conditions or requirements for the provision of assistance and consequences of non-compliance with the Act or the Memorandum of Incorporation will be briefly considered.

Chapter 5 concludes this dissertation.

1.6. Definitions of Terms and Concepts

Term/ Concept	Shall mean
<i>“the Act”</i> or <i>“the New Companies Act”</i>	The Companies Act 71 of 2008
<i>“1973 Act”</i>	The Companies Act 61 of 1973 (as amended by the Companies Law Amendment Act of 1999)
<i>“BEE”</i>	Black Economic Empowerment
<i>“board”</i>	board of directors
<i>“Memorandum”</i>	Memorandum of Incorporation
Reference to any section	Reference to the Companies Act 71 of 2008, unless specified otherwise

2. THE SOLVENCY AND LIQUIDITY TEST²⁵

The provisions in the Act relating to financial assistance which are to be evaluated in the subsequent chapters (Chapters 3 and 4), as well as all other capital rules contained in the Act²⁶, are all based on the solvency and liquidity regime, and all require, at one point or another, the consideration of the solvency and liquidity test as contained in section 4 of the Act. It is therefore important to examine same test and its application at the outset of this study.

Section 4(1) of the Companies Act reads as follows:

“4. (1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all the reasonably foreseeable financial circumstances of the company at that time –

- (a) the assets of the company or, if the company is a member of a group of companies, the aggregate assets of the company, as fairly valued, equal or exceed the liabilities of the company or, if the company is a member of a group of companies, the aggregate liabilities of the company, as fairly valued; and*
- (b) it appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of-*
 - i) 12 months after the date on which the test is considered; or*
 - ii) in the case of a distribution contemplated in paragraph (a) of the definition of “distribution” in section 1, 12 months following that distribution.”*

It is clear from the above that the test involves a solvency element and a liquidity element, both which must be satisfied in order to satisfy the test. I will now proceed to discuss the elements of the above test and how it is to be applied pursuant to the provisions of the Act.

2.1. The Solvency Element

The purpose of the solvency element is to prevent a company from preferring its shareholders above its creditors through a partial liquidation of the company²⁷.

²⁵ The structure of this section is partial based on that of Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

²⁶ Sections 46, 47 and 48

²⁷ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

This entrenches the principle that ultimately creditors enjoy preference above shareholders in a liquidation or winding up of a company²⁸.

The solvency element of the test is set out in section 4(1)(a) of the Act (see above). In simple terms, the solvency test will be satisfied if after the distribution or provision of financial assistance, the assets of the company fairly valued, exceed (or equal) the liabilities of the company²⁹. The solvency test will thus determine the net assets or net liabilities of a company³⁰. This test is also referred to in practice as the “balance sheet test”³¹.

However, this test is complicated by the insertion of the words “*if the company is a member of a group of companies, the aggregate assets (or liabilities) of the company*”³² (my emphasis). A distinction is thus drawn where the company is a member of a group of companies and where it is not³³.

This distinction has however been described as “*obscure*”³⁴ and “*superfluous*”, as the distinction appears to make no difference. Surely what is intended with “assets” and “liabilities” of the company (one which is not a member of a group) is its “aggregate” assets and liabilities³⁵.

A proper distinction could be drawn between the two scenarios if the Act referred to “the aggregate assets (liabilities) of the group”, thus requiring the group’s total assets and liabilities (as contained in the groups consolidated financial statements) to be taken into account³⁶. However, this cannot be theoretically justified³⁷, as this could lead to an insolvent company relying on the good financial state of fellow members in the group when it wants to make a distribution to its shareholders or provide financial assistance, which may not only be members within the group³⁸. This would also infringe the common law principle of separate legal personality³⁹, which has become firmly entrenched in our law. This principle maintains that every company within a group of

²⁸ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

²⁹ Section 4(1)(a) read with s46 (and s44)

³⁰ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

³¹ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

³² Section 4(1)(a)

³³ Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126

³⁴ Delpont *The New Companies Act Manual* 2009 LexisNexis

³⁵ Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126

³⁶ See also Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2 where Van der Linde submits that this is a possible intention of the Legislature at page 227

³⁷ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

³⁸ Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126

³⁹ See *Salomon v Salomon and Co Ltd* [1892] AC 22 [HL]

companies remains a separate legal entity⁴⁰, with its own (separate) assets and liabilities. This interpretation would furthermore go against the ordinary meaning of the words contained in the section⁴¹.

However obscure or superfluous this distinction may be, the question is now what intention the legislature had in adding the words “*aggregate*” where it is a member of a group, as he would not have drawn the distinction if he did not have one in mind or intended for it to serve some purpose. In the first draft of the Companies Bill no reference was made to “*aggregate*” assets or liabilities or anything to that effect, whereas in the further versions of the Bill reference was made to the “*consolidated*” assets of the company⁴². The word “*aggregate*” was only introduced after the fourth version of the Bill was introduced into parliament⁴³. A reason advanced for the change of wording in section 4(1)(a) from “*consolidated*” to “*aggregate*” is that the former is an accounting concept, which may have unintended results⁴⁴. Unfortunately, no firm intention or purpose can be deduced from these changes and it appears that at the end of the day, the only intention that can be deduced is that the aggregate of the company’s own separate assets or liabilities must be considered and not that of the group⁴⁵.

Jooste submits that the only plausible solution is to amend section 4(1)(a) of the Companies Act⁴⁶. He states that the section should be amended to state that a company will only pass the solvency test if each company within the group passes the test. He believes this to not only be a probable intention of the section 4(1)(a) as it stands, but that such an interpretation will also provide creditors with further protection.

Van der Linde agrees that the section should be reconsidered⁴⁷. She suggests that the regulations of distributions (in this context includes financial assistance provided) within a group context should be limited to where a subsidiary makes

⁴⁰ *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530. For a discussion on separate entities within the group context see also Bhana *The Company Law Implications of Conferring a Power on a Subsidiary to Acquire the Shares of Its Holding Company* 2006 Stell LR Volume 17

⁴¹ Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126

⁴² Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126

⁴³ Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126

⁴⁴ Delpont *The New Companies Act Manual* 2009 LexisNexis

⁴⁵ Delpont *The New Companies Act Manual* 2009 LexisNexis

⁴⁶ Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126 at page 641

⁴⁷ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2 at page 227

a distribution to its holding company⁴⁸ and that in such a case both the holding company and subsidiary company must satisfy the test⁴⁹. This makes sense to a certain degree, as this is the greatest possibility for abuse of control, where a holding company, by virtue of its control over the subsidiary company, causes such subsidiary to make a distribution to itself. However, this might not cover all situations of abuse of control where there is a complex structure of a group of companies.

Jooste's suggestion (as above) offers more protection to creditors, especially where complex group structures are at play. However, to put this to practice every time a company wants to make a distribution or provide financial assistance to a person will be too time consuming and costly, and is unnecessarily burdensome. Although Van der Linde's recommendation affords creditors less protection, it might be a more practical solution, one of which the cost and difficulty of application does not outweigh the harm against which the section seeks to protect. This approach is also more in line with the objective of flexibility and simplicity as contained in section 7 of the Act⁵⁰.

However, regardless of which approach is better, should the legislature have intended to have one of the above desired effects, substantive legislative reform will be necessary.

2.2 The Liquidity Element

The liquidity element of the test represents the expectation of a company's creditors to be paid timeously and also supports the representation the company makes in incurring a debt that it reasonably believes it will be able to settle the debt on time⁵¹.

The liquidity element of the test is contained in section 4(1)(b) of the Act. Same element will be satisfied if it appears that a company will be able to pay its debts as they become due in the ordinary course of business for a period of twelve months after the date the test is considered or 12 months after the distribution is made in case of a distribution of money or property⁵².

⁴⁸ In this context will include a subsidiary providing financial assistance for the purpose of or in connection with the subscription or purchase of shares in the holding company, or the provision of financial assistance to the director or public officer of the holding company (Sections 44 and 45 of the Act)

⁴⁹ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁵⁰ Section 7(b)(ii)

⁵¹ Van der Line *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁵² Section 4(1)(b) read with section 46(1)(a)

There are two main approaches to the liquidity test: a net current assets test and a cash flow analysis⁵³.

The net current assets test is calculated with reference to the Statement of Financial Position⁵⁴. The test is applied by subtracting the current liabilities from the current assets. If the answer is positive, the company is deemed to have sufficient current assets over liabilities and thus will be able to satisfy the debts as they become due in the ordinary course of business. This test is also in accordance with the twelve month-rule contained in the liquidity element, as an asset (or liability) is *inter alia* classified as a “current asset” (or “current liability”) if the company “expects to realize the asset (or the liability is due to be settled) within twelve months after the reporting period”⁵⁵.

However, Van der Linde points out that the reference to “debts as they become due in the ordinary course of business” points towards the use of the cash flow analysis⁵⁶. This will most likely be done by use of a cash flow statement. In *International Accounting Standard 7, Statement of Cash Flows* as contained in the International Financial Reporting Standards, the following is stated with regard to the statement of cash flows:

*“A statement of cash flows, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances as opportunities.”*⁵⁷

A Statement of Cash Flows⁵⁸ will report on cash flows of a specific period, classifying such cash flows as operating, investment and financing cash flows. It is thus clear that the cash flow analysis takes into account not only the net current assets, but also the planned (or predicted) activities of the firm and can therefore provide a useful basis for the directors in contemplating the liquidity element.

⁵³ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁵⁴ In terms of International Financial Reporting Standards what used to be called a balance sheet is now called a Statement of Financial Position. As all financial statements and accounting records have to comply with financial reporting standards, I find it appropriate to align the definitions, so as to avoid confusion in interpreting and use of the financial statements.

⁵⁵ *IAS 1 Presentation of Financial Statements* International Financial Reporting Standards 2008/2009, see paragraphs 66(c) and 69(c)

⁵⁶ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2 at 226

⁵⁷ *IAS 7 Statement of Cash Flows* International Financial Reporting Standards 2008/2009 at paragraph 4

⁵⁸ As prepared in accordance with IFRS

It must however be noted, that use of neither of the above tests is right or wrong, and the directors are given a discretion in which test to apply, as the Act does not state specifically which test must be used. The cash flow analysis is however more commonly used⁵⁹.

It must also be taken into account that the Statement of Financial Position and the Statement of Cash Flows as prepared by a company, although useful, must not be looked at in isolation, as unless the time at which the test is considered, is the same time as the financial year end, the 12 month period for which the liquidity element must be satisfied will be different to the 12 month period as contained in the financial statements. Furthermore, the Act requires *all* reasonably foreseeable financial circumstances to be taken into account⁶⁰, and not only those put on paper.

Van der Linde criticises the 12 month time frame (with reference to which the liquidity must be determined), as she contests that each company should be able to decide what the “ordinary course of business” means with reference to its liquidity⁶¹. I cannot agree.

Firstly, I believe the time frame to be useful as it eliminates uncertainty among directors on how to apply the test. It is difficult to see how liability can be imposed on directors if they do not reach a reasonable conclusion if no guideline as to time frame is given. Furthermore, a cash flow prediction cannot be made without reference to a time frame. It will require a lot of extra time and money to determine what time frame would be appropriate for each company and in every circumstance. It also goes against the purpose of the Act to promote economic development by *inter alia* creating simplicity in the maintenance of companies.

Secondly, the time frame is in accordance with both the *JSE Listing Requirements*⁶² and with the accounting principles relating to current assets and liabilities⁶³ as well as that of the cash flow statement⁶⁴.

I therefore deem the timeframe to be appropriate.

⁵⁹ Van der Linde *Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁶⁰ Section 4(1)

⁶¹ Van der Linde *Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2 at page 228

⁶² Paragraph 5.69

⁶³ *IAS 1 Presentation of Financial Statements* International Financial Reporting Standards 2008/2009

⁶⁴ *IAS 7 Statement of Cash Flows* International Financial Reporting Standards 2008/2009

2.3. **Asset Valuation and Information to be used in Consideration thereof**

As quoted above, section 4(1) of the Companies Act requires that in applying the solvency and liquidity test “*all reasonably foreseeable financial circumstances of the company at that time*” must be considered.

Furthermore, section 4(2) requires that:

- “(2) *For purposes contemplated in subsection (1) –*
- (a) *any financial information to be considered concerning the company must be based on –*
 - (i) *accounting records that satisfy the requirements of section 28; and*
 - (ii) *financial statements that satisfy the requirements of section 29;*
 - (b) *subject to paragraph (c), the board or any other person applying the solvency and liquidity test to a company-*
 - (i) *must consider a fair valuation of the company’s assets and liabilities, including any reasonably foreseeable contingent assets and liabilities, irrespective of whether or not arising as a result of the proposed distribution or otherwise; and*
 - (ii) *may consider any other valuation of the company’s assets and liabilities that is reasonable in the circumstances...”*

Section 4(2)(c) as referred to in the above quotation refers to the preferential rights of preference shareholders upon liquidation and will be discussed below⁶⁵.

Section 28 requires a company to keep accurate and complete accounting records, while Section 29 prescribes certain requirements for presentation of financial statements. *Inter alia*, the financial statements (if presented to any person or company) must comply with financial reporting standards.

It thus appears from the above sections that in applying the solvency and liquidity test, one must consider all reasonably foreseeable financial circumstances, and at the point where this concerns the use and interpretation

⁶⁵ See 2.4 below

of financial information, such information must comply with certain requirements⁶⁶.

Van der Linde correctly points out that “*financial information*” has a more limited meaning than “*financial circumstances*”⁶⁷. However, I respectfully disagree with her that both financial information and financial circumstances need to be considered as separate issues when applying the test. I believe consideration of financial information of the company will be included in the contemplation of the financial circumstances, as evidence concerning financial circumstances and reasonably foreseeable financial circumstances will inevitably be deduced from the financial information of the company to a large extent (albeit not in isolation). I believe the interpretation as above to be more practical.

The words “*reasonably foreseeable*” as contained in section 4(1) implies that a certain measure of prediction is necessary in applying the test⁶⁸. This is especially the case as with the liquidity test⁶⁹. I do not believe that this means directors have to explore all potential rises and falls of the company. Directors will often be aware of events or possibilities in the pipeline that could have a material influence on the financial position or circumstances of the company, such as financially significant contracts in the final phase of negotiation, or a possible merger, should the chances of them happening be more likely than not. Information other than what is on the company’s records will therefore have to be considered. As directors will know the company best, what this information will entail, will be best left to be determined by them.

The inclusion of contingent assets and liabilities (as contained in sections 4(2)(c)(i)) in the assessing of a company’s assets and liabilities has been welcomed by some writers⁷⁰, while criticised by others⁷¹.

I agree that the approach should be welcomed, as it not only creates more certainty for directors in their application of the test, but it is also in line with the approach of considering “*all reasonably foreseeable financial circumstances*”, as contingent liabilities may fall into the category of reasonably foreseeable events that may change the financial position of the company.

Contingent assets (and liabilities) are defined as a possible asset (or obligation) arising from past events and whose existence will be confirmed only by the

⁶⁶ Namely section 28 and 29 (see above)

⁶⁷ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2 at page 230

⁶⁸ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁶⁹ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁷⁰ Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126

⁷¹ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

occurrence or non-occurrence of one or more future events not wholly within the control the company⁷². A contingent liability can also be a “*present obligation that arises from past events but is not recognized because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or the amount of the obligation cannot be measured with sufficient reliability*”⁷³.

It can be seen from the definition thereof that contingent assets and liabilities could have a material influence on the financial circumstances of the company as and when they realise, especially with regard to the third alternative to the definition of contingent liability. For example, where a competition tribunal has found a company guilty of an offence punishable by a fine, but has not yet determined the extent of the fine, pending further investigation. The obligation is present and enforceable (once determined), as a result of past events, but the amount of the obligation cannot be measured with certainty. It would thus be important to take the contingent liability into account, although its exact effect cannot be determined at time of consideration of the test.

The Act states that contingent assets and liabilities are to be considered whether or not they arise from a distribution or otherwise⁷⁴. This may be the case where, for example, a company stands surety for a debt of one of its shareholders⁷⁵, where it is not probable that the company will be called to account (i.e. it is improbable that there will be an outflow of resources embodying economic benefits⁷⁶). I submit that the same concept applies with regard to financial assistance⁷⁷.

Although contingent assets and liabilities are not recognised in the Statement of Financial Position⁷⁸, they are required to be disclosed in the notes to the financial statements, unless the inflow of economic benefits is not probable or the outflow of resources embodying economic benefits is remote⁷⁹. The financial statements and notes thereto (as prepared in accordance with financial

⁷² IAS 37 *Contingent Assets and Liabilities* International Financial Reporting Standards 2008/2009 at paragraph 10

⁷³ IAS 37 *Contingent Assets and Liabilities* International Financial Reporting Standards 2008/2009

⁷⁴ Section 4(2)(b)(i)

⁷⁵ This qualifies as a distribution in terms of section 48 of the Act

⁷⁶ IAS 37 *Contingent Assets and Liabilities* International Financial Reporting Standards 2008/2009

⁷⁷ I.e. whether a contingent asset or liability arises as a result of the provision of financial assistance, or otherwise, it must be taken into account. This view will be included by virtue of the words “*or otherwise*” as contained in section 4(2)(b)(i)

⁷⁸ IAS 37 *Contingent Assets and Liabilities* International Financial Reporting Standards 2008/2009 at paragraphs 27 and 31

⁷⁹ IAS 37 *Contingent Assets and Liabilities* International Financial Reporting Standards 2008/2009 at paragraphs 28 and 34

reporting standards) will therefore be a useful guide in the evaluation of contingent assets and liabilities.

I respectfully disagree with Van der Linde that the contingent assets and liabilities are not required to be reflected in the financial statements in terms of international accounting standards and international financial reporting standards, as in terms of these standards, the notes to the financial statements form part of a “*complete set of financial statements*”⁸⁰. The notes are thus required as an intricate part of the financial statements themselves.

A last aspect to be covered under this subsection is that of the “*fair valuation*”⁸¹ versus “*any other valuation... that is reasonable in the circumstances*”⁸². Many writers are of the opinion that it is difficult to see how any valuation can be reasonable in the circumstances that is not a fair valuation⁸³.

Albeit limited circumstances, I do believe that there can be situations where a valuation other than the fair valuation will be justified as “*reasonable in the [specific] circumstances*”. For example, certain assets are built for a particular purpose, such as specialised equipment built for a specific project. The use of same may be limited due to the nature of the asset. As a result of the limited use of the equipment outside of that project, the fair value in the market, or the net realisable value outside of the project, will be different to the fair value placed on that equipment at present due to its integral nature to the project. Where such assets are expected to be sold at the end of the project, it might be wise of the directors to place a fair valuation of the assets outside of the project on same assets.

Albeit these examples are far and few in between, I deem it useful to have the option. As directors know the company and their plans for the company’s assets and liabilities best, the valuation of same assets and liabilities is best left up to them.

It may be useful to include a provision in the company’s Memorandum that where directors decide to use a valuation other than the fair valuation, they must provide reasons as to why they believe they are justified to do so.

⁸⁰ See *IAS 1 Presentation of Financial Statements* International Financial Reporting Standards at paragraph 10 where it states “A complete set of financial statements comprises: a) Statement of Financial Position as at the end of the period; ... (e) notes, comprising. ..other explanatory information”. Disclosure of contingent assets and liabilities fall into this latter category of notes.

⁸¹ Section 4(2)(b)(i)

⁸² Section 4(2)(b)(ii)

⁸³ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

2.4 Preferential Rights of Shareholders upon Liquidation

In terms of section 4(2)(c), unless the Memorandum provides otherwise, where the solvency and liquidity test is applied to a distribution in terms of paragraph (a) of the definition of a distribution⁸⁴ (namely a transfer of money or property), any preferential rights of shareholders on liquidation, should not be taken into account.

It thus appears that in applying the solvency and liquidity test to distributions other than those in terms of paragraph (a) of the definition, therefore also in cases of financial assistance, preferential liquidation rights must be taken into account⁸⁵. This is again subject to the Memorandum.

An alternative interpretation is that in the case of distributions other than by way of transfer of money or property, preferential liquidation rights should never be taken into account⁸⁶, regardless of the Memorandum. I tend to agree with the former interpretation, as it provides shareholders with more protection, and is not to the detriment of creditors.

There is no clear reason for this distinction⁸⁷ with regard to preferential liquidation rights. A possible justification is that the effects of a transfer of money or property can be felt or seen immediately. Thus, if it can be seen that the company will be solvent after a transfer of money or property, it is clear no liquidation is imminent and threatening and thus the preferential rights of shareholders upon liquidation need not be taken into account. However, where (for example) the company incurs a debt on behalf of a shareholder, the debt may only become payable at a future date⁸⁸ and the effects thereof will be more difficult to predict. It might thus be necessary to take into account the preferential rights of other shareholders upon liquidation.

It must however be noted that it appears that the company is free to regulate this aspect in its Memorandum. It would be wise to do so, as shareholders will then be aware of their position in this regard.

⁸⁴ Section 46

⁸⁵ Jooste *Issues Relating to the Regulation of "Distributions" by the 2008 Companies Act 2009* SALJ Volume 126

⁸⁶ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁸⁷ Jooste *Issues Relating to the Regulation of "Distributions" by the 2008 Companies Act 2009* SALJ Volume 126; Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁸⁸ See Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2 at page 231 where she explains that "debt" and "obligation" as used in section 4 bear the same meaning

Van der Linde correctly points out that it would have been more advisable for the legislature to require preferential liquidation rights to be taken into account in all scenarios, subject to the Memorandum, as in such instance creditors and preferential shareholders would always be protected, subject to the Memorandum. If the Memorandum excluded this protection, the preferential shareholders would be aware of this at the outset⁸⁹.

Where preferential liquidation rights are to be taken into account, it will only have an effect on (the consideration of) the solvency element of the test, as such rights cannot be seen as debts due “*in the ordinary course of business*”⁹⁰.

2.5. **Timing Issues**

A distinction must be drawn between the time at which the solvency and liquidity test should be considered and the time with reference to which the test must be applied⁹¹.

Both these timing issues will be discussed with reference to the relevant rules.

2.6. **General Comments about the Test**

There seems to be consensus that the solvency and liquidity test is an objective one⁹². There must be some reason or ground that can reasonably justify a conclusion of solvency and liquidity⁹³. However there appears to be some disagreement about from whose perspective this applies.

Van der Linde submits that the test must be applied from the perspective of an objective bystander⁹⁴. Jooste argues that it is from the perspective of a hypothetical reasonable board of directors⁹⁵. I agree with Jooste. As it is the board of directors who are given the task of considering and applying the solvency and liquidity test, it is the perspective of a reasonable board that is relevant.

⁸⁹ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2 at page 233

⁹⁰ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁹¹ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁹² Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2; Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126

⁹³ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

⁹⁴ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2 at page 234

⁹⁵ Jooste *Issues Relating to the Regulation of “Distributions” by the 2008 Companies Act* 2009 SALJ Volume 126 at page 642

Jooste correctly points out that if the legislature intended for the knowledge, skill and experience of a particular board was to be taken into account (thus adding a subjective element to the test), it should have been made clear in the Act⁹⁶.

The sections covering the capital rules often add a subjective element to the test. Same will be discussed in the relevant chapters.

It is clear from the wording and additional duties added by sections 44 and 45 that there is a positive duty on the board of directors to apply the solvency and liquidity test. This will be apparent from the chapters to follow.

A last comment that has to be made about the test and its application is the inconsistency among the sections containing capital rules in the application of the test by its directors. Sections 44 and 45 state that the board must be "satisfied" that the company will satisfy the test; in section 46 the board must acknowledge by resolution that they have "considered" the test and "reasonably concluded" it will be satisfied; section 47 requires compliance with section 46 and that the board must "consider" the test and be satisfied that the test will be satisfied; and section 48 again requires compliance with section 46. What the difference between "satisfied" and "reasonably concluding" is and the difference between applying and considering the test is, is not clear. Consistency is needed in this regard⁹⁷.

It is clear from the above that the solvency and liquidity test will play a large role in practice, especially in the lives of directors, and will not fall into place without any problems. Some problems can be ironed out by courts and practice, whereas others can only be rectified via legislative reform⁹⁸.

This concludes the chapter on the solvency and liquidity test. I will now proceed to discuss the rules of financial assistance as contained in section 44 and 45 of the Act.

⁹⁶ Jooste *Issues Relating to the Regulation of "Distributions" by the 2008 Companies Act* 2009 SALJ Volume 126 at page 642

⁹⁷ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2; Jooste *Issues Relating to the Regulation of "Distributions" by the 2008 Companies Act* 2009 SALJ Volume 126

⁹⁸ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008* 2009 TSAR Volume 2

3. FINANCIAL ASSISTANCE FOR THE SUBSCRIPTION OF SHARES (SECTION 44)

Under the Old Act (as amended) the provision of financial assistance for the purpose of or in connection with the purchase of shares in the company was prohibited with certain limited exceptions⁹⁹. Under the New Act such financial assistance is allowed, subject to fulfillment of certain requirements¹⁰⁰.

The legislature can be applauded for this shift in approach as the prohibition against financial assistance has often been described as an “*occasional embarrassment to the honest, without being a serious inconvenience to the unscrupulous*”¹⁰¹. It has often prevented innocent transactions¹⁰² and has hampered transformation in South Africa. This is rectified by the Act.

The new section will provide momentum to transformation in South Africa, as financially stable companies will now be able to provide financial assistance to BEE partners, so as to enable them to acquire shares¹⁰³. Where this takes the form of lending money, the company will be able to lend such money to the empowerment partner at an interest rate lower than the bank¹⁰⁴. Where it is cheaper for such partners to acquire the shares, they will be able to acquire more, thereby providing further momentum for transformation¹⁰⁵.

3.1. The Basic Allowance

Section 44(2) of the Act provides that:

“To the extent that the Memorandum of Incorporation provides otherwise, the board may authorise the company¹⁰⁶ to provide financial assistance by way

⁹⁹ Section 38 of the 1973 Act. This rule developed as a statutory extension of the common law rule that a company may not acquire its own shares, as the provision of financial assistance by a company for the purchase or subscription of shares in itself is an indirect way of acquiring and trafficking in its own shares. The scope of the prohibition however extended beyond protecting against the aforementioned in that it also aims at prohibiting a person with insufficient funds and credit from gaining control of the company. See Cilliers, Benade, Henning, Du Plessis, Delpont, De Koker, Pretorius *Cilliers & Benade Corporate Law, 3rd Edition* 2000 LexisNexis Butterworths at page 328; and S Patel *Making it easier to finance share purchases* Without Prejudice, May 2007 (2007 Volume 7 Number 4)

¹⁰⁰ Section 44

¹⁰¹ Jenkins Report 1926. Although the comments were made with reference to the English Companies Act equivalent of section 38, the quotation is often used in criticism of section 38. See *Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (A)*.

¹⁰² P L Davies *Gower and Davies Principles of Company Law 8th Edition* 2008 Sweet&Maxwell

¹⁰³ Patel *Making it easier to finance share purchases* Without Prejudice, May 2007 (2007 Volume 7 Number 4)

¹⁰⁴ Patel *Making it easier to finance share purchases* Without Prejudice, May 2007 (2007 Volume 7 Number 4)

¹⁰⁵ Patel *Making it easier to finance share purchases* Without Prejudice, May 2007 (2007 Volume 7 Number 4)

¹⁰⁶ Delpont correctly points out that it is not the board that authorises the company to provide financial assistance, but that the correct construction is that the company authorises the board as its representatives. See Delpont *The New Companies Act Manual* 2009 LexisNexis at page 31

of a loan, guarantee, the provision of security or otherwise to any person for the purpose of, or in connection with, the subscription of any option, or any securities, issued or to be issued by the company or a related or inter-related company, subject to subsections (3) and (4)”.

Subsection 3 states that despite any provision in the company’s Memorandum, the board may not authorise any financial assistance (as above), unless the provision of such assistance is:

- i) pursuant to an employee share scheme that satisfies the requirements of section 97¹⁰⁷, or
- ii) pursuant to a special resolution of the shareholders. Such special resolution must have been adopted within the previous two years and must approve such financial assistance either for a specific recipient or generally for a category of potential recipients and the specific recipient must fall within such category¹⁰⁸.

Subsection 3 furthermore requires that the board must be “*satisfied*” that:

- i) the company would satisfy the solvency and liquidity test immediately after providing the financial assistance¹⁰⁹; and
- ii) the proposed terms under which the financial assistance is to be given are “*fair and reasonable to the company*”¹¹⁰.

Section 4 requires that in addition to the duties of the board as above, the board must make sure that any conditions or restrictions (relating to financial assistance) contained in the company’s Memorandum are complied with.

I will now proceed to analyse the section and its application in further detail.

3.2. Definitions of Terms and Concepts

3.2.1. “*Financial Assistance*”

Financial assistance does not include lending money in the ordinary course of business by a company whose primary business is the lending of money¹¹¹, such as a bank.

¹⁰⁷ Section 44(3)(a)(i)

¹⁰⁸ Section 44(3)(a)(ii)

¹⁰⁹ Section 44(3)(b)(i)

¹¹⁰ Section 44(3)(b)(ii)

¹¹¹ Section 44(1)

Financial assistance is not defined in the Act. However as the wording contained in section 44 that describes (types of) financial assistance regulated by the provision, namely “*financial assistance by way of a loan, guarantee, the provision of security or otherwise*” is the same as in the Old Act, the extensive case law that developed around the definition thereof will remain applicable¹¹².

The words “*or otherwise*” indicate that the examples of financial assistance given is not an exhaustive list. The question is thus what would qualify as financial assistance, other than that by way of a loan, guarantee and the provision of security. Financial assistance for the purpose of or in connection with purchase of shares that take aforementioned forms obviously qualifies as financial assistance for purposes of section 44, and therefore does not require further discussion under this heading.

In *Gradwell (Pty) Ltd v Rostra Printers Ltd*¹¹³ the court formulated the ‘impoverishment test’. The impoverishment test entails an enquiry into the company’s state of financial affairs. If the company has become poorer as a result of a transaction for purpose of or in connection with a purchase of shares, financial assistance had been given¹¹⁴. This approach was followed by the courts for many years.

However, in 1979 Miller JA specifically warned against the use of this test, in what has to date become the leading case with regard to financial assistance, namely *Lipschitz v UDC Bank Ltd*¹¹⁵. The learned judge pointed out that although the test may prove to be useful in certain instances, it may be completely irrelevant in others¹¹⁶. It will largely depend on the type of financial assistance given¹¹⁷. For example, where the company stands surety for a person in order to enable that person to acquire resources to buy shares, the company will not necessarily be impoverished. However, the assets of the company are exposed to a risk, and the legislature clearly intended this type of assistance to be struck by the section (as it is specifically included). It is thus clear that the impoverishment test will not be effective in all instances that are intended to be covered by the section.

¹¹² Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹¹³ 1959 (4) SA 419 (A)

¹¹⁴ Cilliers, Benade, Henning, Du Plessis, Delpont, De Koker, Pretorius *Cilliers & Benade Corporate Law, 3rd Edition* 2000, LexisNexis Butterworths

¹¹⁵ 1979 (1) SA 789 (A)

¹¹⁶ *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A)

¹¹⁷ *Lipschitz v UDC Bank Ltd* 1979 (1) SA 789 (A)

In cases where the impoverishment test cannot be used, the judge pointed out that the company's financial position and those of other persons involved as well as other relevant circumstances, could be relevant in determining whether the financial assistance was given "*for the purpose of or in connection with*" the purchase of shares.

It is a pity that the legislature did not use the opportunity to clarify the matter of what constitutes financial assistance¹¹⁸.

3.2.2. "***For the purpose of or in connection with***"

What would qualify as "*for the purpose of or in connection with*" the subscription of options or securities can also be determined with reference to existing case law, for the same reasons as stated above.

What will qualify as "*for the purpose of*" can obviously be given its literal meaning and should be easy to determine in practice. It is therefore necessary to determine meaning or practical implication of the words "*in connection with*".

The Lipschitz-case¹¹⁹ is (again) the leading authority in this regard. Miller JA pointed out that "*in connection with*" may have a very wide connotation if given its literal meaning and that it is seldom that words as contained in legislation are given their literal meaning¹²⁰. He further held that "*in connection with*" is an alternative for "*for the purpose of*" and therefore "*in the context of the section its connotation cannot be otherwise than profoundly affected by the concept to which it is an alternative*"¹²¹. "*in connection with*" will thus be applicable where there is a significantly close relationship between the financial assistance and the subscription of securities, but where the specific purpose cannot be determined¹²². The words were therefore merely inserted to close possible loopholes and are not intended to create a different type of offence¹²³.

Therefore in determining whether financial assistance was given in connection with the subscription of securities, one has to bear the above in mind.

¹¹⁸ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹¹⁹ Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (A)

¹²⁰ Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (A) at [804]

¹²¹ Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (A) at [804]

¹²² Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (A)

¹²³ Lipschitz v UDC Bank Ltd 1979 (1) SA 789 (A)

It must be noted at this point, that section 38 of the Companies Act of 1973 imposed a criminal sanction on directors for contravention of the Act. As same is not done in section 44 of the Act, in that only civil liability is imposed, the courts might interpret the section more widely.

3.2.3. “**Purchase**” and “**Subscription**”

Subject to certain conditions financial assistance may be provided for the subscription of any option, or securities, issued or to be issued by the company or a related or inter-related company, or for the purchase of any securities of the company or inter-related company.

The words “*subscription*” and “*purchase*” are not defined in the Act and should be afforded its ordinary meaning.

A “purchase” of the company’s shares involves the acquisition of shares from another shareholder of the company (or related or inter-related company), whereas “subscription” involves acquiring shares from the company (or related or inter-related company) itself¹²⁴.

3.2.4. “**Securities**”

Section 44 regulates financial assistance for subscription or purchase of options or securities of the company (or related or inter-related company).

The Act does not state what the “option” is for¹²⁵. The logical deduction one would make is that it is an option for the subscription or purchase of securities in the company (or a related or inter-related company)¹²⁶. I submit that this is the intended interpretation of the legislature and the one that should be followed.

The express inclusion of provision of financial assistance for acquisition of “options” is welcomed. As options may at a later date be converted into securities (which if they had been directly acquired would have been struck by section 44), it is important that they are regulated by section 44 as well, as otherwise this would be an easy way to circumvent the section. Although there is a possibility that the option may never be exercised (and thus there is no purchase or subscription of securities), the harm which the section protects against is greater than the inconvenience caused by compliance

¹²⁴ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹²⁵ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹²⁶ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

with the section. The certainty created in this regard can therefore be applauded¹²⁷.

Securities are in turn defined in section 1 of the Act as having the meaning as set out in section 1 of the Securities Services Act 36 of 2004 and including shares held in a private company.

Securities are defined in the Securities Services Act¹²⁸ as follows:

“securities” –

(a) means –

- i) shares, stocks and depository receipts in public companies and other equivalent equities, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980);
- ii) notes;
- iii) derivative instruments;
- iv) bonds;
- v) debentures;
- vi) participatory interests in a collective investments scheme as defined in the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002) and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investment Schemes in terms of section 65 of that Act;
- vii) units or any other form of participation in a collective investment scheme licensed or registered in a foreign country;
- viii) instruments based on an index;
- ix) the securities contemplated in subparagraphs (i) to (viii) that are listed on an external exchange; and
- x) an instrument similar to one or more of the securities contemplated in subparagraphs (i) to (ix) declared by the registrar by notice in the Gazette to be a security for purposes of this Act;

¹²⁷ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹²⁸ 36 of 2004

- xi) rights in securities referred to in subparagraphs (i) to (x);
- (b) excludes –
 - (i) money market instruments;
 - (ii) any security contemplated in paragraph (a) specified by the registrar by notice in the Gazette”

Convertible debentures will be covered by the above section, and thus in cases where financial assistance is provided for the purchase or subscription thereof, section 44 will apply. It is helpful that clarity has been given with regard to this matter.

From the above it can be seen that section 44 of the Act casts a much wider net (and a very wide net at that) than financial assistance for purchase or subscription of shares only and many transactions that were not previously affected will now be. If financial assistance is provided for the purpose of or in connection with subscription or purchase of any of the above items, such agreement or transaction will have to comply with the requirements of section 44.

3.2.5. “**Related or Inter-related Company**”

A company has to comply with the requirements of section 44 where it provides financial assistance to any person for the purpose of or in connection with the subscription or purchase of securities¹²⁹ not only in the company itself, but also in a related or inter-related company.

In terms of section 2(1)(c) of the Act a company is related or inter-related to another company¹³⁰ if:

- i) either of them directly or indirectly controls the other, or business of the other as determined in accordance with subsection (2);
- ii) either is a subsidiary of the other;
- iii) a person directly or indirectly controls each of them or the business of each of them, as determined in accordance with subsection (2).

Subsection 2 determines that a person controls a company or its business, if:

- i) the company is a subsidiary of the aforementioned person¹³¹; or

¹²⁹ Includes options for securities

¹³⁰ The Act uses the term juristic person

- ii) that first person (controlling person) together with any related or inter-related person is able to exercise (or control the exercise of) a majority of the voting rights associated with the securities of the company, whether pursuant to a shareholders' agreement or otherwise¹³²; or
- iii) that first person (controlling person) together with any related or inter-related person has the right to appoint or elect (or control aforementioned) directors of the company who control a majority of the votes at board meetings; or
- iv) that first person has the ability to materially influence the policy of the company in a manner comparable to a person who, in the ordinary commercial practice, would be able to exercise an element of control as aforementioned¹³³.

For purposes of points (ii) and (iii) directly above it will be necessary to determine whether two persons are related or inter-related.

Two individuals are related or inter-related if they are married or live together in a relationship similar to marriage,¹³⁴ or are separated by no more than two degrees of natural or adopted consanguinity or affinity¹³⁵.

An individual is related or inter-related to a company¹³⁶ if the individual directly or indirectly controls the juristic person as determined in accordance with subsection (2) (see above)¹³⁷.

Whether two persons that are companies are related or inter-related was explained above.

It is important to note that an extensive enquiry might therefore be necessary in order to determine whether two parties are related or inter-related, to determine whether they exercise combined control. For example, where one seeks to determine whether two juristic persons are related or inter-related, it will have to be determined (in terms of subsection (2)) whether a person

¹³¹ As determined in accordance with section 3(1)(a). This section contains the definition of subsidiary. The principles of what qualifies as a subsidiary company have remained relatively unchanged and therefore I do not deem it necessary to embark on a discussion thereof.

¹³² Section 2(2)(a)(ii)

¹³³ Section 2(2)(d)

¹³⁴ Section 2(1)(a)(i)

¹³⁵ Section 2(2)(a)(ii)

¹³⁶ Or other juristic person

¹³⁷ In the enquiry of whether a person or individual is related or inter-related to a juristic person, where the juristic person is a close corporation or a trust, see subsections 2(b) and (c) in order to determine the control element as required in terms of subsection 1.

directly or indirectly controls each of them. In order to determine whether a person directly or indirectly controls its business, one would have to look at how the directors are appointed or elected. If two persons together have the right to appoint the majority of directors, one will have to determine whether they are related or inter-related. A second enquiry will thus have to be embarked on to determine aforementioned. The process is thus repeated more than once.

As can be seen above, the definition of a related or inter-related company is formulated in very broad terms and thereby extends the application of section 44 significantly. Where a holding company wishes to provide financial assistance for the purchase of shares in a subsidiary or subsidiary of a subsidiary¹³⁸, such holding company will have to comply with section 44. A subsidiary wanting to provide financial assistance for the purchase of shares in a fellow subsidiary will similarly have to comply with section 44.

It will be difficult to determine whether financial assistance to a person for the purchase or subscription of shares in another company falls within the ambit of section 44, where a group of companies has a complicated group structure¹³⁹.

The inclusion of “related or inter-related” companies was clearly aimed at countering an abuse of control situation. However, the section seems to go a bit far.

Section 2(3) enables a court, the Companies Tribunal or the Takeover Regulation Panel to exempt a person from a provision in the Act, if the person (the company) can show that, with regard to a certain matter, he acts independently of any related or inter-related person. Although this might be useful, it will be time-consuming and expensive for the company¹⁴⁰, thereby making it less likely to be used as often in practice.

3.3. Analysis of Conditions or Requirements

3.3.1. Special Resolution

If the financial assistance is not pursuant to an employee share scheme that satisfies the requirements of section 97 of the Act, a special resolution is required¹⁴¹. Such resolution may approve the assistance for a specific

¹³⁸ Section 44 read with section 2(1)(c)(ii)

¹³⁹ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹⁴⁰ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹⁴¹ Section 44(3)(a)(ii)

recipient or for a general category of recipients, and must have been adopted within the previous two years¹⁴².

The purpose of the special resolution is to protect the shareholders¹⁴³. However, this protection afforded may potentially be greatly diminished by allowing a special resolution to be passed for a general category of recipients¹⁴⁴. There is nothing in the Act prohibiting a company from passing a special resolution allowing financial assistance to a general category of shareholder that is so widely framed that the directors are in effect given a discretion as to whom they can provide financial assistance to¹⁴⁵. For example, nothing in the Act prohibits a resolution allowing financial to recipients who, in the opinion of the directors, would further a certain object of the company, such as transformation¹⁴⁶. This negates the protection afforded shareholders to a great extent, if not completely.

It must however be noted that shareholders are also protected in other ways by section 44, such as the solvency and liquidity requirements¹⁴⁷ and the requirement that the terms of assistance must be fair and reasonable¹⁴⁸. However, I do not believe the legislature would have afforded shareholders the protection by special resolution if he intended that the effects thereof could be significantly diminished.

I am therefore of the opinion that in proposing and passing the special resolution the “general category of recipients” should not be formulated too widely. Clarity is however called for in this regard¹⁴⁹.

3.3.2. Solvency and Liquidity Requirements

The board may not authorise any provision of financial assistance, unless it is satisfied that immediately after providing the financial assistance, the company would satisfy the solvency and liquidity test.

The fact that the board has to be “satisfied” shows that this is a subjective test¹⁵⁰. This goes further than the test as it is formulated in section 4 of the Act, as such test is purely an objective one. I submit that the test in this

¹⁴² Section 44(3)(a)(ii)

¹⁴³ Patel *Making it easier to finance share purchases* Without Prejudice, May 2007 (2007 Volume 7 Number 4)

¹⁴⁴ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹⁴⁵ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹⁴⁶ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹⁴⁷ Section 44(3)(b)(i)

¹⁴⁸ Section 44(3)(b)(ii). Note that this will not apply with regard to section 45.

¹⁴⁹ This can be clarified either by interpretation by the courts, or legislative reform.

¹⁵⁰ Delpont *The New Companies Act Manual* 2009 LexisNexis

regard must be applied subjectively in that the board, in applying the test as it stands in section 4 (thereby considering all reasonably foreseeable financial circumstances) must, taking into account their knowledge, skill and experience, satisfy itself and be confident that the company will *actually*¹⁵¹ be solvent and liquid after providing the financial assistance. There must, however, be reasonable grounds for believing the view that they have expressed, thereby taking into account the objective element of the solvency and liquidity test¹⁵².

Section 44(3)(b)(ii) requires the board to be satisfied that the company will satisfy the solvency and liquidity test “*immediately after providing the financial assistance*”.

As explained above¹⁵³ a distinction must be drawn between the time at which the test is considered and the time with reference to which is must be considered¹⁵⁴. The test should be considered at the time the proposed financial assistance is intended to be provided¹⁵⁵ and such test must be applied with reference to the moment “*immediately after providing the financial assistance*”¹⁵⁶, thereby taking into account the effect of the financial assistance.

A problem arises where the financial assistance lasts for a long duration of time. However, in applying the solvency and liquidity test this will be considered as all reasonably foreseeable financial circumstances are to be taken into account in terms of section 4(1)(a).

The question arises as to when and with reference to which timeframe the test must be applied where options or convertible debentures are concerned. I do not see this to pose a major problem. As section 44 expressly regulates subscription or purchase of options, and also includes debentures by virtue of the definition of securities, the test must be applied same as above, and not at the time at which the option is exercised or debenture converted and with reference to the moment after exercise or conversion. This is because the test must be considered and applied at the moment at which the financial

¹⁵¹ Delpont *The New Companies Act Manual 2009* LexisNexis. See also Yeats & Jooste *Financial Assistance – A New Approach 2009* SALJ Volume 126 Issue 3

¹⁵² Van der Linde *Solvency and Liquidity Approach in the Companies Act 2008 2009* TSAR Volume 2

¹⁵³ See Chapter 2

¹⁵⁴ Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008 2009* TSAR Volume 2

¹⁵⁵ On analysis of distribution by way of money or property in terms of section 46 and section (a) of the definition of distribution as considered in Van der Linde *The Solvency and Liquidity Approach in the Companies Act 2008 2009* TSAR Volume 2

¹⁵⁶ Section 44(3)(b)(i)

assistance is provided¹⁵⁷. The legislature clearly intended financial assistance for the purpose of or in connection with the subscription or purchase of options and debentures to be regulated, and this intent should be given effect to. If financial assistance is again provided at the point of exercise of the option or conversion of debenture, section 44 and therefore the test must be applied again.

The interaction between section 4(1) and section 44(3)(b)(i) is not very clear and I foresee that interpretation difficulties will occur in practice. Hopefully these will be clarified by practice, courts or the legislature as soon as practicably possible.

3.3.3. “*Fair and Reasonable*” Terms

The board furthermore has to be satisfied that the terms of financial assistance proposed to be given are “*fair and reasonable to the company*”¹⁵⁸. This will provide shareholders with protection in that the assets of the company cannot be applied for senseless purposes or in a manner that is not in the best interest of the company, thereby diminishing their shareholder value.

The Act does not define “*fair and reasonable to the company*”. Yeats and Jooste embark on a lengthy discussion as to what this may mean and from whose perspective it must be viewed¹⁵⁹. However, I do not deem it necessary to go into extensive detail as to what will be “*fair and reasonable to the company*”, as same will depend on the circumstances of each case. Many factors may play a role, such as financial considerations, what security is given for the assistance, the opportunities the financial assistance may bring (for example acquiring more government contracts where the level of BEE is significantly increased), and conditions of repayment to name but a few.

I think Patel proposes the best solution in that he considers the term to mean that “*in the opinion of the board, the financial assistance must be on commercially acceptable and sound terms and be in the best interest of the company*”¹⁶⁰. I think this is a practical approach, as the directors of a company are best suited to decide what is fair and reasonable to the company in the circumstances. If the board can satisfy itself that the terms of

¹⁵⁷ Consideration can be paid for options, therefore it is possible to provide financial assistance for same, see section 40 of the Act.

¹⁵⁸ Section 44(3)(b)(ii)

¹⁵⁹ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

¹⁶⁰ Patel *Making it easier to finance share purchases* Without Prejudice, May 2007 (2007 Volume 7 Number 4)

the transaction are commercially acceptable and sound, and in the best interest of the company, I do not see how they can go wrong.

3.3.4. **Restrictions or Conditions in the Memorandum of Incorporation**

Section 44(2) allows a company to impose conditions or restrictions on the provision of financial assistance. In turn, it is the duty of the directors to ensure that all conditions or restrictions contained in the company's Memorandum are complied with or have been satisfied¹⁶¹. This is over and above the duties as set out above.

This will enable a company to provide further protection to creditors and shareholders, where a company deems the protection afforded by the Act to be insufficient.

3.4. **Consequences of Non-compliance with the Act or a provision in the Memorandum of Incorporation**

A decision by a board to provide financial assistance, or any agreement to provide such assistance, is void to the extent that such provision of financial assistance would be inconsistent with section 44 of the Act¹⁶², or with any prohibition, condition or restriction contained in the Memorandum of the company¹⁶³.

It must however be noted that section 218(1) of the Act states that no agreement or resolution that is void, voidable or may be declared unlawful in terms of the Act, is void, unless the court declares it so. Therefore, any agreement inconsistent with the Act or the company's Memorandum of Incorporation will have to be declared void by court in terms of section 218(1) for it to be "*actually*"¹⁶⁴ void¹⁶⁵.

In considering whether to declare an agreement for financial assistance inconsistent with the Act or the company's Memorandum of Incorporation void, the court will obviously take into account that section 44 renders such agreement void. This should play a large role (if not an overriding one) in making its decision.

The words "*to the extent...that it is inconsistent*"¹⁶⁶ indicate that any resolution or agreement to provide financial assistance is void only to the extent that it

¹⁶¹ Section 44(4)

¹⁶² Section 44(5)(a)

¹⁶³ Section 44(5)(b)

¹⁶⁴ Delpont *The New Companies Act Manual 2009* LexisNexis

¹⁶⁵ Delpont *The New Companies Act Manual 2009* LexisNexis

¹⁶⁶ Section 44(5)

is inconsistent with the Act or Memorandum. It is therefore possible that any part of such agreement that is consistent with the Act or the company's Memorandum, can be severed from the rest of the resolution or agreement (if possible). The inconsistent part will therefore be declared void, while the remainder, if severable, will remain valid and intact. This might have unintended results. It would therefore be advisable for companies to regulate this aspect in the resolution or agreement itself, by making it clear (for example by inserting a conditional clause in an agreement) that should any part of the resolution or agreement be declared void, the entire resolution or agreement will lapse.

Where a resolution or agreement for the provision of financial assistance has been declared void by court in terms of section 44(5) and section 218(1), the directors of the company may be held personally liable.

A director may be held liable where he was present at the meeting in which the board approved the financial assistance, or participated in making the decision in terms of section 74, and failed to vote against the resolution or agreement, despite knowing that the provision of financial assistance would be inconsistent with section 44 or any prohibition, condition or restriction imposed by the company's Memorandum¹⁶⁷.

Section 74 regulates directors' action other than at meetings. The section provides that any decision that could be voted on at a meeting of the board of directors, may instead be adopted by written consent of a majority of the directors, given either in person or by electronic communication, as long as every director received notice of the matter to be decided on. This can be done away with or restricted by further conditions or requirements in the Memorandum¹⁶⁸. The effect of a decision made in this manner is the same as if it had been approved by voting at a board meeting¹⁶⁹.

The extent of the liability is the loss, damage or costs sustained by the company as a result of the director's failure to vote against the resolution or agreement, as above¹⁷⁰. The director's liability will be joint and several with any other director who is liable for the same act¹⁷¹. The liability is however

¹⁶⁷ Section 44(6)

¹⁶⁸ Section 74 commences with the words "*Except to the extent that the Memorandum of Incorporation provides otherwise*"

¹⁶⁹ Section 74(2)

¹⁷⁰ Section 45(6) read with section 77(3)(iv)

¹⁷¹ Section 77(6)

limited to the extent that the resolution or agreement has been declared void¹⁷².

It must be noted that the definition of “*knowing*” is very wide. In terms of section 1 “*knowing*,” “*knowingly*” or “*knows*” means that a person (with regard to a particular matter) either had:

- i) actual knowledge of the matter¹⁷³; or
- ii) was in position where he reasonably ought to have had actual knowledge¹⁷⁴; investigated the matter to the extent that he would have had actual knowledge¹⁷⁵; or taken measures which if taken would reasonably have been expected to provide him with actual knowledge of the matter¹⁷⁶.

It is thus clear that the definition of “*knowing*” as contained in the Act is a lot wider than its ordinary meaning. A director therefore has to take reasonable steps in ensuring that he is well informed about any agreement or resolution to be passed, whether he is planning on voting or not.

A situation may arise where a resolution is passed in terms of section 74, via the use of electronic mail, and a director consented to the resolution by non-response (for example where the resolution states that no reply will be construed as agreeing or approving the resolution). The director might now be held liable, even though he possibly did not even read the email, on the basis that he failed on voting against the resolution, despite knowing (in the sense that he was in a position where he ought to have taken measures to acquire actual knowledge, such as read his electronic mail) that the provision was in contravention of section 44.

I would suggest that the company’s Memorandum should exclude section 74 resolutions (unanimous assent without a meeting) for the passing of resolutions or agreements concerning the provision of financial assistance as a restriction or condition on such provision of financial assistance. If this is not done, directors might be exposed to unnecessary risk.

¹⁷² Section 45(6) read with section 77(3)(iv)

¹⁷³ Paragraph (a) of the definition of “*knowing*”, “*knowingly*” or “*knows*” as contained in Section 1

¹⁷⁴ Paragraph (b)(i) of the definition of “*knowing*”, “*knowingly*” or “*knows*” as contained in Section 1

¹⁷⁵ Paragraph (b)(ii) of the definition of “*knowing*”, “*knowingly*” or “*knows*” as contained in Section 1

¹⁷⁶ Paragraph (b)(iii) of the definition of “*knowing*”, “*knowingly*” or “*knows*” as contained in Section 1

It must however be noted that personal liability of directors will serve as a great protection measure for shareholders and creditors, in that directors are forced to perform their duties properly and not be negligent in a any regard.

3.5. **Conclusion**

Although the legislature can be applauded for the approach to the provision of financial assistance for the subscription or purchase of options or securities in a company as embraced in the Act and the benefits flowing there from, this section is not without its problems. The scope of the application of the section is extremely wide, an directors will be faced with a difficult task in determining not only whether the test applies, but also whether all requirements are complied with. Interpretation and application of the section does not prove to be easy and clarity is called for in certain regards.

4. FINANCIAL ASSISTANCE TO DIRECTORS OR RELATED OR INTER-RELATED COMPANIES (SECTION 45)

Directors are in a position of control within a company, in that they are in charge of the running of and the administration of the company's business and its funds. Due to this power and control they are able to exercise over the company's funds, there is a great possibility of abuse¹⁷⁷. Strict governance and rules and regulations are therefore necessary when it comes to what they may and may not do with the company's funds, especially where they stand to benefit.

Whereas previously loans to directors were prohibited, with certain limited exceptions¹⁷⁸, while loans to holding companies were allowed, subject to disclosure requirements¹⁷⁹, all financial assistance to directors and to related companies, is now regulated under one provision in the Act, namely section 45. As will be seen below, the application of this section is case incredibly wide and the requirements for the provision of financial assistance in terms thereof is rather stringent.

4.1. The Basic Allowance

Section 45(2) provides as follows:

“Except to the extent that the Memorandum of Incorporation of a company provides otherwise, the board may authorise the company to provide direct or indirect financial assistance to a director or prescribed officer of the company or of a related or inter-related company or corporation, or to a member of a related or inter-related, or to a person related or inter-related to any such company, corporation, director, prescribed officer or member, subject to subsection (3) and (4).”

Subsection 3 requires that regardless of anything to the contrary contained in a company's Memorandum, the board may not authorise financial assistance as above unless:

- i) it is pursuant to an employee scheme that satisfies the requirements of section 97¹⁸⁰; or
- ii) it is pursuant to a special resolution of the shareholders, adopted within the previous two years and approving such financial assistance either for a

¹⁷⁷ Cilliers, Benade, Henning, Du Plessis, Delpont, De Koker, Pretorius *Cilliers & Benade Corporate Law, 3rd Edition* 2000, LexisNexis Butterworths

¹⁷⁸ Section 226 of the 1973 Act

¹⁷⁹ Section 37 of the 1973 Act

¹⁸⁰ Section 45 (3)(a)(i)

specific recipient or generally for a category of potential recipients, and the specific recipient must fall within such category¹⁸¹; and

- iii) the board must be satisfied that the company would satisfy the solvency and liquidity test immediately after providing the financial assistance¹⁸².

Subsection (4) requires the board to ensure that any conditions or restrictions regarding the granting of financial assistance contained in the company's Memorandum have been satisfied.

Furthermore, subsection (5) requires that where a resolution is passed in terms of subsection (2), notice of same must be given to every shareholder of the company¹⁸³ and to any trade union representing its employees as follows:

- i) if the total value of the loans, debts and obligations contemplated in the resolution, together with any previous resolutions of this kind adopted during the current financial year, exceeds one tenth of 1% (i.e.0.001%) of the company's net worth at the time of the resolution, the notice must be given within 10 business days after the board has adopted the resolution;
- ii) in any other circumstances, within 30 days after the end of the financial year.

It must be noted that many concepts and exact phrases contained in section 44 are repeated in section 45. The conditions or requirements which need to be satisfied in order for financial assistance to be provided are identical subject to a few differences. Therefore a lot of what has been analysed and explained above, will also be relevant with regard to this chapter. Some however will be pointed out below.

4.2. Definitions of Terms and Concepts

4.2.1. “Financial Assistance”

The lending of money, guaranteeing of a loan or other obligation, or securing a debt or obligation is expressly included in the definition of “*financial assistance*”¹⁸⁴. Expressly excluded is the lending of money in the ordinary course of business where the company's primary business is the lending of money¹⁸⁵; accountable advances to meet legal expenses in relation to a

¹⁸¹ Section 45 (3)(a)(ii)

¹⁸² Section 45(3)(b)

¹⁸³ Unless every shareholder is also a director

¹⁸⁴ Section 45(1)(a)

¹⁸⁵ Section 45(1)(b)(i)

matter concerning the company¹⁸⁶, or anticipated expenses to be incurred by the person on behalf of the company¹⁸⁷; or an amount to cover a person's expenses for removal at the company's request¹⁸⁸.

This last exclusion is not stated in very clear terms. Better wording would have been "*an amount to defray the expenses for removal of the person at the company's request*"¹⁸⁹. Expenses likely to be included hereunder are those incurred by a director under section 71(4) in challenging his proposed removal¹⁹⁰.

It is submitted that where it is unclear if a certain act or agreement constitutes financial assistance for the purposes of section 45, the definition of financial assistance as explained in relation to section 44 should be applied (see 3.2.1 above). The legislature was well aware of the connotation and the extensive body of case law that has developed around the term "financial assistance" over the past years, and would not have used this term if he did not intend its accompanying meaning (except for where he expressly states the contrary).

4.2.2. "**Direct or Indirect**"

Subject to the requirements "*direct or indirect*" financial assistance may be provided.

This term is relatively self-explanatory. Direct financial assistance will be where the company provides a direct loan to the director¹⁹¹ or a related company. Examples of indirect financial assistance are guaranteeing a loan or obligation of a director, or securing a debt or obligation of a director. As the definition of financial assistance expressly includes all these scenarios, and it is difficult to see how a form of financial assistance will not fall within these scenarios, the inclusion of the words "*direct or indirect*" appears to be unnecessary. I believe the purpose of such insertion to be the closing of any (potential) loopholes.

4.2.3. "**Director or prescribed officer**" and "**corporation**"

¹⁸⁶ Section 45(1)(b)(ii)(aa)

¹⁸⁷ Section 45(1)(b)(ii)(bb)

¹⁸⁸ Section 45(1)(b)(iii)

¹⁸⁹ Webber Wentzel Attorneys *Snapshot 12: Financial Assistance to directors and related or inter-related parties* Newsletter October 2009, www.wwb.co.za (Direct link: http://mailstreams.cambrient.com/mailstreams/admin/mailer_instance/view.jsp?mailerid=1805&mid=2481)

¹⁹⁰ Webber Wentzel Attorneys *Snapshot 12: Financial Assistance to directors and related or inter-related parties* Newsletter October 2009, www.wwb.co.za

¹⁹¹ Director in this context includes all parties to whom if financial assistance is provided by a company, will be regulated by the section, as determined in accordance with section 45(2) read with section 2

Financial assistance to *inter alia* directors and corporations or members thereof is regulated by section 45.

A director is a member of the board or an alternate director¹⁹². This includes persons who are *de facto* a member of the board or alternate director, but given another name¹⁹³. An alternate director is person elected to serve as a member on the board, when necessary, in substitution for an elected or appointed director of the company¹⁹⁴.

At this point it is not clear what a “*prescribed officer*” is. In terms of section 1 a “*prescribed officer*” means the holder of an office, within a company, that has been designated by the Minister in terms of section 66(11). This is clearly a referencing error, as section 66(11) is completely unrelated to the matter of “*prescribed officers*”. The correct section is section 66(10). The Minister has not made such a designation to date.

As stated above, section 45 also regulates the provision of financial assistance to a related or inter-related “*corporation*” or member thereof¹⁹⁵. Corporation is not defined in the Act, but presumably this is reference to a close corporation¹⁹⁶.

4.2.4. Related and Inter-related Relations

Financial assistance is regulated by section 45 where it is provided by a company to:

- i) a director or prescribed officer of the company;
- ii) a director or prescribed officer of a related company;
- iii) a related or inter-related company or corporation;
- iv) a member of a related or inter-related corporation; or
- v) to a person related to any of the above parties.¹⁹⁷

The definition and explanation of what qualifies as a related or inter-related company was explained above (Section 3.2.5). The same principles apply

¹⁹² See Section 1 definition of “*director*”

¹⁹³ See Section 1 definition of “*director*”

¹⁹⁴ See Section 1 definition of “*alternate director*”

¹⁹⁵ Section 45(2)

¹⁹⁶ Webber Wentzel Attorneys *Snapshot 12: Financial Assistance to directors and related or inter-related parties* Newsletter October 2009, www.wwb.co.za

¹⁹⁷ Section 45(2)

here. A loan or other financial assistance to the related or inter-related company itself, or to a director or prescribed officer thereof, as determined in accordance with aforementioned principles, will be struck by section 45.

It is interesting to note that even intra-group loans are struck by the provision. It is also clear from this inclusion, that what was intended by the legislature with the words “*aggregate assets...if the company is part of a group of companies*” in the solvency element of the solvency and liquidity test as contained in section 4(1)(a) of the Act, was not for the entire group’s assets to be taken into account, as in such a case there would be absolutely no difference in financial position of the group when an intra-group loan is made, thus making application of the test pointless.

It is clear from the above that the net of application of section 45 is cast incredibly wide. A company wishing to provide financial assistance to just about anyone or anything even remotely related to itself or another company within the group will have to comply with section 45. Companies will have to be very thorough in their enquiry into related or inter-related persons when wanting to provide financial assistance to a person or company.

4.3. **Analysis of Conditions or Requirements**

The requirements that the financial assistance must be pursuant to an employee share scheme or special resolution; that the board of directors must ensure that the financial assistance must satisfy any conditions in the Memorandum and that directors must be satisfied that the company will satisfy the solvency and liquidity test immediately after the provision of the assistance, are worded in the same manner as section 44 and with the same underlying principles in mind. The analysis of the conditions or requirements as contained in 3.3.1, 3.3.2 and 3.3.4 above therefore applies *mutatis mutandis* to aforementioned conditions of section 45. I therefore deem it unnecessary to repeat same here.

It is strange to note that Act does not require the terms of assistance to be “fair and reasonable” as is the case with section 44. Shareholders and employees are however protected through requirements of disclosure (see 4.3.1 below). It is also difficult to see how a board of directors who is independent, will authorise the provision of financial assistance to a director or prescribed officer or to another company, if the terms of such assistance are not fair and reasonable.

Furthermore, where the financial assistance proposed to be given is to a director within the company itself, such director should not be entitled to vote at

the meeting at which the provision of such financial assistance is contemplated, as such director will obviously not be impartial and not be able to adjudicate the matter with an unfettered discretion. It will be advisable for a company to regulate this aspect in its Memorandum¹⁹⁸.

4.3.1. **Notice to Shareholders and Representative Trade Unions**

A requirement set in section 45 that is not in section 44 is that of notice to shareholders and trade unions.

The requirements as to the notice are set out in section 45(5) and were stated above (see 4.1).

The purpose of this subsection is to protect the shareholders and employees. Where the terms of the financial assistance would be harmful to the company, or where the shareholders or trade unions of employees believe that the financial assistance as contemplated in the resolution will not satisfy the requirements of section 45 or any conditions contained in the Memorandum, such shareholders or employees (via their trade union) will be entitled to oppose the provision of such assistance.

Shareholders or trade unions can oppose the proposed financial assistance by the use of the derivative action in terms of section 165 of the Act. Both shareholders of the company or a related or inter-related company and registered trade unions are given *locus standi* for purposes of this action. A detailed discussion of what this derivative action entails falls outside the scope of this study.

4.4. **Consequences of Non-compliance with the Act or a provision in the Memorandum of Incorporation**

A board resolution to provide financial assistance in terms of subsection (2), or an agreement to provide such financial assistance, is void to the extent that the provision of such assistance would be inconsistent with section 45¹⁹⁹ or with a prohibition, condition or requirement contained in the Memorandum of Incorporation²⁰⁰.

¹⁹⁸ A company will be entitled to do so as section 45(2) states that "Except to the extent that the Memorandum of Incorporation provides otherwise". Furthermore, section 45(4) requires the board to be satisfied that any conditions or restrictions in the company's Memorandum of Incorporation must be complied with. If not, directors may be held personally liable in terms of section 45(7). It is thus clear that a company is free to insert additional conditions or requirements in its Memorandum of Incorporation and that such provision are treated as if it were inserted in the Act.

¹⁹⁹ Section 45(6)(a)

²⁰⁰ Section 45(6)(b)

If a resolution or an agreement for the provision of financial assistance has been declared void in terms of section 218(1), a director of the company is liable for any loss, damage or cost sustained by the company if the director was present at the meeting when the resolution or agreement was approved, or participated in making the decision in terms of section 74 and failed to vote against such decision, despite knowing that the provision of financial assistance was inconsistent with section 45 or a prohibition, condition or requirement contained in the Memorandum of Incorporation²⁰¹. Liability is limited to the extent that the agreement or resolution declared void²⁰².

As the wording of section 45(6) which determines the validity of an agreement or resolution that is inconsistent with section 45 or the Memorandum of Incorporation is the same as its equivalent in section 44 (section 44(5), the discussion of last mentioned section as contained in 3.4. above will apply equally to section 45(6). Similarly, as the liability of directors as imposed in terms of section 45(7) read with section 77(3)(e)(v) is the same as its equivalent contained in section 44(6) read with section 77(3)(e)(iv), both in terms of the circumstances under which liability is imposed and the extent of such liability, the discussion of same as contained in 3.4. above will again apply here.

4.5. **Conclusion**

From the above it can be seen that section 45 is worded and structured in a very similar fashion to section 44. This is however appropriate as these two provisions are based on similar underlying principles and protects against similar harms.

The greatest problem with the section is the incredibly wide extent of its application, much wider than that of its predecessor²⁰³. This may prove to be a burden in practice.

²⁰¹ Section 45(7) read with section 77(3)(e)(v)

²⁰² Section 45(7) read with section 77(3)(e)(v)

²⁰³ Section 226 of the 1973 Act

5. CONCLUSION

It is commendable that the Act has finally done away with all remnants of the capital maintenance principle, and replaced the system with one based on solvency and liquidity. This not only brings us in line with international jurisdictions, but also provides for more flexibility within companies. Creditors and shareholders also appear to be provided with sufficient protection in the majority of instances.

However, as can be seen from the above study, the transformation from a capital maintenance regime (or one partially based thereon) to one based on solvency and liquidity, will not prove to be one without speed bumps.

The solvency and liquidity test as contained in section 4 of the Act and the provisions relating to financial assistance, namely sections 44 and 45 contain a number of anomalies and interpretation problems that are in need of clarification. Furthermore, the scope of application of section 44 and section 45 is cast incredibly wide, mainly as a result of the inclusion of related or inter-related parties in all instances, as well as the wide definition of securities contained in section 44. This will prove to be great burden in practice.

Furthermore, although a host of problems were identified in the study, many further issues will arise once the provisions relating to financial assistance find commercial application²⁰⁴. It can only be hoped that the uncertainties and anomalies contained in the Act will be clarified by practice, the courts, and where necessary substantive legislative reform, as soon as practicably possible.

All in all however, the change to a solvency and liquidity approach is positive one and one can only applaud the legislature for finally taking such a bold step. No transformation is without its problems and where a system is replaced with a completely alternative one, one cannot expect the new system to work 100% at its outset. Fortunately, therefore, the system can only be improved on from here. Although it might take some time to eliminate problems and ensure the effective working of the system, the benefits the system will provide in the long term will outweigh the initial hurdles.

²⁰⁴ Yeats & Jooste *Financial Assistance – A New Approach* 2009 SALJ Volume 126 Issue 3

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Note with Regard to Footnotes

The initials of authors were used in the first reference to an article, whereafter only reference to surnames were made.